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USA: Legal aspects of securities lending and repo
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ABSTRACT: Despite the substantial volume of securities lending transactions in the US, the regulations are limited, pertaining mostly to banks, brokers, and dealers in securities. Control and primary governance of securities lending are dictated by the contractual terms and provisions agreed to by the parties in such transactions. Federal Reserve System Regulation T states that a broker or dealer may borrow or lend securities for the purpose of making delivery of the securities in the case of short sales, failure to receive securities required to be delivered, or other similar situations. It also provides that each borrowing must be secured by one or more of the following: cash, securities issued or guaranteed by the US or its agencies, negotiable bank certificates of deposit and bankers acceptances issued by banking institutions in the US and payable in the US, or irrevocable letters of credit issued by a FDIC-insured bank or a foreign bank that has filed an agreement with the Board on Form FR T-2. Other securities regulations are discussed.

TEXT: Securities lending in the US is a multi-billion dollar business which can be traced back several decades. In recent years the volume of securities lending has increased rapidly. Competition has reduced margins in domestic transactions resulting in more US institutions willing to lend their international securities. Since these transactions involve securities and the volume of lending is substantial, one would expect the regulations to be quite extensive. However, the regulations are limited, pertaining mostly to banks, brokers and dealers in securities. Control and primary governance of securities lending are dictated by the contractual terms and provisions agreed to by the parties in such transactions.

This article explains a typical securities lending transaction conducted in the US, will discuss the major regulations or industry customs, and set forth some concerns which arise. The scope will be limited to the extent of providing a basic understanding of securities lending and will not discuss the statutes, regulations and case law relating to tax issues

THE TYPICAL TRANSACTION
Although securities lending can involve several parties acting in varying capacities, the most common type of transaction involves three participants: the lender, who has eligible securities to loan, the borrower, who borrows securities to cover a position or operational need, and the agent who has a securities lending program established to facilitate such transactions.

Institutions such as private and public pension funds, endowments, foundations, mutual funds, banks, unions and life insurance companies are typically the lenders, although individuals also participate as lenders. The lender will loan securities in order to generate incremental income which will offset trustee and custodial fees, and improve portfolio performance. The income produced per transaction is nominal, but the overall effect is substantial due to the volume of securities being lent.

Borrowers are usually securities firms (brokers and dealers) or commercial banks. At times, individuals, and institutions normally considered lenders,

will borrow securities. Borrowers typically use the borrowed securities for settlement of securities fails, short sales and sophisticated arbitrage and option positions.

Commercial banks are typically the agents in securities lending transactions. Often these banks are already acting in the capacity of a trustee or custodian for the lender. The agent usually receives its fee out of the income or fees received by the lender.

In most instances, the agent will enter into separate agreements with the lender and the borrower. The duration of the loans given are usually open-ended. The basic structure has the agent, with the lender's permission, lending eligible securities (such as corporate equities, corporate bonds and government securities) from the lender's portfolio to an approved borrower in return for a fee.

As part of the overall transaction, the borrower must give collateral to the lender. The value of the collateral given must be equal to at least 100% of the market value of the securities loaned. One of the agent's primary responsibilities is to mark-to-market the collateral on a daily basis, thereby insuring that the securities lent are neither over or under-collateralized. Such correction is accomplished by either having the borrower supply more collateral when there is a deficit in collateral value or having the agent return some of the collateral when there is a surplus in collateral value. The agent also locates the borrowers, invests any cash collateral and provides record keeping and other services.
The collateral given is often cash, but can include pledged securities or irrevocable letters of credit. When cash is the collateral, the agent will invest the cash and credit the interest earned to the account of the lender after deducting its fee. The borrower will usually receive a rebate fee from the agent when the cash collateral is returned. If the collateral consists of securities or an irrevocable letter of credit, the agent will receive a fixed fee from the borrower upon the return of the collateral. The fee received from the borrower is paid to the lender after deduction of the agent's fee.

The interest which the lender has in the collateral (and the agent on the lender's behalf) is that of a secured party with a security interest in such collateral. If the borrower fails to return the loaned securities under the conditions specified in the agreement between it and the agent, the agent will purchase replacement securities and liquidate the collateral to pay for the replacement securities. Unless the agent provides some level of protection or indemnification to the lender, the lender bears the risk of any loss.

Regulation of securities lending transactions

Federal Reserve System--Regulation T As stated in the introduction, many of the federal regulations apply to brokers and dealers, whether acting in the capacity of a lender or a borrower. Regulation T (12 CFR Part 220--Credit by Brokers and Dealers) is a key provision to brokers and dealers. Regulation T was issued by the Board of Governors of the Federal Reserve System to regulate the extensions of credit by and to brokers and dealers.

Section 220.16 of Regulation T states that a broker or dealer may borrow or lend securities for the purpose of making delivery of the securities in the case of short sales, failure to receive securities required to be delivered, or other similar situations. The section also provides that each borrowing must be secured by a deposit of one or more of the following: cash, securities issued or guaranteed by the US or its agencies, negotiable bank certificates of deposit and bankers acceptances issued by banking institutions in the US and payable in the US, or irrevocable letters of credit issued by a bank insured by the Federal Deposit Insurance Corporation or a foreign bank that has filed an agreement with the Board on Form FR T-2.

Finally, the collateral deposited must have, at all times, a value at least equal to 100% of the market value of the securities borrowed, computed as of the close of the preceding business day.
SUPERVISORY POLICY

On May 6 1985 the Federal Reserve Board issued a press release concerning the adoption of a supervisory policy drafted by the Federal Financial Institutions Examination Council concerning securities lending. The Office of the Comptroller of the Currency adopted the same policy in Banking Circular Number 196, dated May 7 1985. The purpose of the policy is to provide standards of safety and soundness for financial institutions acting as lenders and agents. The supervisory policy recommends that all financial institutions engaged in securities lending establish written policies and procedures which, at a minimum, address the following topics:

* Record-keeping. An adequate record-keeping system must be established and kept updated. At a minimum, the system should produce daily reports showing the status of the securities, the outstanding loans (by borrower and count) and transactions by account.

* Administrative procedures, Collateral must be marked-to-market daily and there must be procedures to ensure that any necessary margin calls are made on a timely basis. There should be internal controls and periodic internal audits.
* Credit analysis and approval of borrowers. A duly established management or supervisory committee should formally approve transactions with any borrower in advance. Independent credit reviews should be conducted prior to approval and at regular intervals thereafter.

* Credit and concentration limits. Management should establish individual credit and concentration limits.

* Collateral management, Generally, the minimum initial collateral on securities loans is at least 102% of the market value of the loaned securities, plus any accrued interest on debt securities. The acceptable level of excess, non-cash collateral should relate to the price volatility of the loaned securities and the collateral. Finally, securities should not be loaned unless collateral has been received or will be simultaneously received with the securities loan.

* Cash collateral. Written guidelines should be established for selecting investments for cash collateral.

* Letters of credit as collateral. Written guidelines should be established for the use of letters of credit. Concentration limits on the banks issuing letters of credit should also be established.
* Written agreements. There should be detailed written agreements between the lender and the agent and the borrower and the agent.

* Finders. Finders bring together a borrower and a lender for a fee. Written policies should be in place concerning the use of Finders. Finders should not take possession of the collateral or securities and should not be involved in the delivery process.

* Employee benefits plans. Any institution engaged in lending securities for an employee benefits plan subject to the Employee Retirement Income Security Act of 1971 (Erisa) should take all steps necessary to design and maintain its program to conform to Prohibited Transition Exemptions 81-6 and 82-63.

* Indemnification. Agents offering indemnification to lenders should get written opinions from their counsel and accountants regarding the legality of the indemnification under federal and/or state law and the proper financial statement disclosure of actual or contingent liabilities,

respectively.

* Regulatory reporting. Financial institutions should follow the proper reporting requirements.
The supervisory policy applies to national banks and all state-chartered banks that have joined the Federal Reserve System.

Securities Exchange Commission--Rule 15c3-3

Brokers and dealers are also regulated by several rules under the Securities Exchange Act of 1934. Specifically, Rule 15c3-3 (17 CFR Sec 240.15c3-3--Customer Protection-Reserves and Custody of Securities) directly impacts the actions of brokers and dealers with respect to securities lending. Paragraph (b)(1) of the rule generally provides that a broker or dealer shall promptly obtain and maintain the physical possession or control of all fully-paid securities and excess margin securities carried by a broker or dealer for the account of customers. Since the definition of customer under Rule 15c3-3 is quite encompassing, a broker or dealer would not be able to enter into securities lending transactions with a customer's securities. However, paragraph (b)(3) provides an exception to retaining physical possession by providing that a broker or dealer shall not be deemed to be in violation of the provisions of paragraph (b)(1) if the broker or dealer and the lender, at or before the time of the loan, enter into a written agreement that, at a minimum;

* Sets forth in a separate schedule or schedules the basis of compensation for any loan and generally the rights and liabilities of the parties as to the borrowed securities;

* Provides that the lender will be given a schedule of the securities actually borrowed at the time of the borrowing of the securities;

* Specifies that the broker or dealer (A) must provide to the lender, upon the execution of the agreement or by the close of the business day of the loan if the loan occurs subsequent to the execution of the agreement, collateral, consisting exclusively of cash or US Treasury bills and Treasury notes or an irrevocable letter of credit issued by a bank as defined in Section 3(a) (6)(A)-(C) of the Securities Exchange Act which fully secures the loan of securities, and (B) must mark the loan to the market not less than daily and, in the event that the market value of all the outstanding securities loaned at the close of trading at the end of the business day exceeds 100 per cent of the collateral then held by the lender, the borrowing broker or dealer must provide additional collateral of the type described in proviso (iii)(A) above to the lender by the close of the next business day as necessary to equal, together with the collateral then held by the lender, not less than 100 percent of the market value of the securities loaned; and
* Contains a prominent notice that the provisions of the Securities Investor Protection Act of 1970 may not protect the lender with respect to the securities loan transaction and that, therefore, the collateral delivered to the lender may constitute the only source of satisfaction of the broker's or dealer's obligation in the event the broker or dealer fails to return the securities.

DEPARTMENT OF LABOR PROHIBITED TRANSACTION EXEMPTIONS 81-6 AND 82-63

Pension plans, in terms of the dollar amount of securities available for lending, account for a large percentage of the lenders. Until January 23 1981, pension plans subject to Erisa, were not permitted to lend securities because the brokers, dealers or banks would be considered parties in interest with respect to the pension plans. The Department of Labor issued two exemptions for Erisa plans. Prohibited Transaction Exemption 81-6 (46 FR 7527) issued January 23, 1981 (with corrections made at 46 FR 10570 issued February 3 1981 and amendments made at 52 FR 18754 issued May 19 1987) allowed Erisa plans to participate in lending securities under

certain conditions. These conditions are quite extensive but basically provide that the following items must be met:

* Neither the borrower nor an affiliate of the borrower has discretionary authority or control with respect to the investment of the plan assets involved in the transaction, or renders investment advice with respect to those assets;

* The plan receives from the borrower collateral consisting of cash, securities issued or guaranteed by the US Government or its agencies or instrumentalities, or irrevocable bank letters of credit issued by a person other than the borrower or an affiliate thereof, or any combination thereof having a market value equal to not less than 100% of the market value of the securities lent;

* Prior to the making of any such loan, the borrower shall have furnished the lending fiduciary with the most recent available audited and unaudited statements of the borrower's financial condition;

* The loan is made pursuant to a written loan agreement, the terms of which are at least as favourable to the plan as an arm's-length transaction with an unrelated party would be;

* The plan either receives a reasonable fee or has the opportunity to derive compensation through the investment of cash collateral;
* The collateral is marked-to-market and adjusted accordingly;

* The loan may be terminated by the plan at any time; whereupon the borrower must deliver security certificates identical to the borrowed securities, to the plan within (i) the customary delivery period for such securities, (ii) five business days, or (i) the time negotiated for such delivery, whichever is lesser; and

* In the event the loan is terminated, and the borrower fails to return the borrowed securities or the equivalent thereof within the time described in paragraph 7, above, (i) the plan may, under the terms of the loan agreement, purchase securities identical to the borrowed securities (or their equivalent as described above) and may apply the collateral to the payment of the purchase price, any other obligations of the borrower under the agreement, and any expenses associated with the sale and/or purchase, and (ii) the borrower is obligated, under the terms of the loan agreement, to pay, and does pay to the plan the amount of any remaining obligations and expenses not covered by the collateral plus interest at a reasonable rate.

Prohibited Transaction Exemption 82-63 (47 FR 14804) issued April 6 1982 (with corrections made at 47 FR 16437 issued April 16 1982) allowed the fiduciaries of Erisa plans to be compensated for services provided in lending securities under certain conditions. The conditions generally provide that:

* The loan of securities is not prohibited by section 406(a) of the Erisa;

* The lending fiduciary is authorized to engage in securities lending transactions on behalf of the plan;

* The compensation is reasonable and is paid in accordance with the terms of a written instrument; and

* The compensation is subject to the prior written authorization of an independent plan fiduciary and may be terminated by the authorizing fiduciary.

STOCK EXCHANGES

New York Stock Exchange (NYSE)--Paragraph (a) of Rule 296 of the NYSE (Liquidation of Securities Loans and Borrowings) provides that when members or member organizations have entered into an arrangement for the lending and borrowing of securities with each other, each member or member organization shall have the right to liquidate the transaction whenever the other party:

* applies for or consents to, or is the subject of an application for, the appointment of or the taking of possession by a receiver, custodian, trustee, or liquidator of itself or of all or a substantial part of its property;

* admits in writing its inability, or becomes generally unable, to pay its debts as such debts become due;

* makes a general assignment for the benefit of its creditors; or

* files, or has filed against it, a petition on under Title 11 of the US Code, or has filed against it an application for a protective decree under Section 5 of the Securities Investor Protection Act of 1970.

Rule 296 further provides that said liquidation right is available unless stayed, avoided or otherwise limited by an order under the Securities Investor Protection Act of 1970 or any statute administered by the Securities and Exchange Commission. Finally, paragraph (b) of Rule 296 states that no member or member organisation shall lend or borrow any security to or from any non-member except pursuant to a Mitten agreement.

Chicago Stock Exchange (CSE)--The primary CSE provisions governing the lending of securities are found in Rules 1 through 5 of Article XXIV. The rules are as follows:

Rule 1. Return of Securities Loaned Unless otherwise agreed, securities loaned may be returned on the next full business day following the day on which notice of intention to return the loan is made.

Rule 2. Notice of Intention to Demand Return The lender may require the return of a loan of securities on the next full business day following the day on which notice of intention to demand return of the loan is made.

Rule 3. Payment of Interest and Premium When securities are loaned, any premium payable by the borrower or the interest payable by the lender, shall be at such rates as are agreed upon.

Rule 4. Contract Not Affected An agreement to pay a premium because of a failure to deliver securities shall not change the nature of the contract and premiums on each subsequent day shall be payable only by mutual agreement. When any such agreement has been made, the party failing to receive shall be regarded as having waived his right to close out the contract under the rule on that day.

By mutual agreement a failure to deliver may be changed to a loan of securities in which event the contract shall be subject to all the rules applying to such loans.

Rule 5. Floor Employees Prohibited from Borrowing or Lending No floor employee of the exchange shall take any part in the borrowing or lending of securities.

American Stock Exchange (ASE)--ASE Rule 812 (Security Loans) indicates that if a party to a transaction is partially unsecured due to a change in market value, then that party can make a demand on the other party for an amount covering the difference between the contract price and the market price. Rules 860 through 866 of the ASE also dictate some of the mechanics of security loans, such as the payment, settlement, maturity and notice

provisions.

INVESTMENT COMPANY ACT OF 1940

An agent offering a securities lending program to lenders should use care in the structuring of its program. The investment of cash collateral on a pooled basis for the benefit of several lenders may present issues of whether the pooled fund constitutes an investment company within the definition of the Investment Company Act of 1940 (the Act).

This issue was raised in a no action ruling request in the First National Bank of Boston Fed. Sec. L Rep. (CCH 79,444). The First National Bank of Boston requested a no action ruling with respect to its securities lending program which pooled the cash collateral from several borrowers. The ruling request described the lending program and requested that the SEC rule that the program did not constitute an investment company. The SEC responded by stating that on the basis of the facts and representations it did not agree with The First National Bank of Boston's legal analysis. The SEC could not assure that it would not recommend that the Commission take any action against the Bank under the Act if the fund of cash collateral the Bank obtained and invested from borrowers of the securities it held in various fiduciary capacities was not registered under the Act.

However, even if the fund may be an issuer for purpose of the definition of the Act one or more exemptions may exclude it from the definition under Section 3(c) of the Act.
ARE OF CONCERN RISK OF LOSS

The participants in a securities lending transaction recognise that there are several risks inherent in such a transaction. Agreements between lenders and agents typically provide that the lender bears the risk of loss unless the agent is guilty of gross negligence or wilful misconduct.

One area of concern is that of the investment of cash collateral by the agent. If the market value of the securities the agent invested in declines, the primary issue is who bears the risk of loss. Lenders have traditionally attempted to reduce the risk of loss by obtaining indemnification protection from the agents. In recent years most agents have become less willing to include indemnification provisions in their agreements with lenders. Indemnification provisions vary in degree of coverage and depend on the parties' bargaining power and the economics of the transaction. Another element is the question of how losses in a securities lending program are allocated. Program's which pool all the cash collateral for investment may provide that losses are shared by all of the participants or losses maybe charged only to the lender directly affected by the loss.

If the agent is a bank, another indemnification issue is whether the bank has authority to indemnify the lender. In a Comptroller Staff Interpretative Letter (Letter No. 376, dated October 25, 1986) the Comptroller of the Currency indicated that national banks have the authority to provide indemnification. The Comptroller found that indemnification by national banks was an incidental activity to the securities lending business. Whether a state-chartered bank has the authority to provide indemnification is dependent on the banking statutes in the state where the bank is incorporated. As noted in the Supervisory Policy, agents should obtain written legal opinions as to the legality of indemnification under federal and/or state law.

Finally state-chartered banks that are members of the Federal Reserve System and bank holding companies must take into account the capital requirements necessary for indemnification provisions under the Risk-Based Capital Guidelines issued on January 18 1989 by the Federal Reserve System. Such banks must allocate capital to support the amount of their indemnification exposure. If the loan is fully collateralized with cash,

government securities or letter of credit, then the liability is in the 20% category; that is 20% of the value of the loan is a risk-weighted asset. Thus, such indemnity will have a minimum capital requirement of 20% of eight percent of the indemnified amount on a risk-weighted basis or 1.6%.

BANKRUPTCY

A related risk of loss issue concerns the bankruptcy of the agent, borrower or the entity in which the agent invested the cash collateral. Typically the lender and agent have provided for the bankruptcy of a non-lender participant in their contract. The main question involves the mechanics of proceeding against the collateral, if necessary. Section 362(a) of the United States Bankruptcy Code (the Code) provides that a petition for bankruptcy operates as an automatic stay against any entities attempting to gain possession or control of the asses in the bankrupt's estate, unless a court permits such action or an exception, such as Section 362(b)(6), applies. Basically, Section 362(b)(6) provides for the setoff by financial parties of any mutual debt and claim under or in connection with various contracts, including securities contracts. (See In re Amcor Funding Corp., 117 BR 549 (D Ariz 1990) where the court analyzed the legislative history of Section 362(b)(6) to indicate its purpose.)

Furthermore, Section 555 of the Code provides that certain lenders may liquidate securities contracts, pursuant to their contractual liquidation rights, in spite of an automatic stay. Section 555 qualifies this exception by stating that a liquidation can be delayed under the Securities Investor Protection Act of 1970 or the federal securities laws. According to an October 30 1990 letter from the Securities Investor Protection Corporation (SIPC), SIPC indicated that it would not seek court orders to delay such liquidations if the collateral was cash or letters of credit.

CONCLUSION

This article sets forth some of the major regulations in the US regarding securities lending and also presents basic concepts and issues surrounding a typical securities lending transaction. The business is large and growing. It facilitates a need of the securities industry and enables owners of large portfolios to increase their yields. However, there are complex business and legal issues involved which lenders should be aware of, analyze and monitor when participating in securities lending programs.

THIS IS THE FULL-TEXT.
GEOGRAPHIC NAMES: US

DESCRIPTORS: Securities regulations; Securities lending; Repurchase agreements; Regulation of financial institutions; Bankruptcy; Risk assessment
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The Barings Crisis: Complex jigsaw of trades emerging - How the deal was made and lost
RICHARD LAPPER
Financial Times, P 2
Monday, February 27, 1995

TEXT:
Full details of the derivatives trades which triggered the crisis at Barings have yet to emerge, but several pieces of what could prove to be a highly complex jigsaw are already tentatively in place.

The loss-making deals by the Barings trader, who was based in the bank's Singapore office, involved derivatives with a value reflecting - and moving in parallel with - the Nikkei 225 stock index, a contract listed on the Osaka Securities Exchange in Japan and the Singapore International Monetary Exchange, as well as on the Chicago Mercantile Exchange. The deal is thought to have involved trading in both Osaka and Singapore.

The trader is understood to have bought at least 20,000 - and according to some reports up to 40,000 - of these contracts expiring in mid-March, presumably on the assumption that their price would go up with the underlying stock market. Each point of the Nikkei 225 futures contract carries a value of Y1,000, so with the Nikkei 225 trading at levels between 18,000 and 20,000 in the first few weeks of this year, each future would have a value of some Y18m-Y20m (Pounds 117,000-Pounds 130,000).

Although the futures are straightforward instruments bearing no relation to the complex notes traded in the over-the-counter market, the size of the trades is regarded as exceptionally large by derivatives specialists.

'For a medium-sized bank 1,000 contracts was a bloody big trade; 10,000 of these contracts would be a very big deal indeed,' said one consultant.

Assuming the purchase of 20,000 contracts and a fall in price from Y19.6m to Y17.6m, losses would amount to Y40bn.

During the first few weeks of 1995, the value of the Nikkei fell, declining by about 6.5 per cent in the first three weeks of February.

Like other exchanges, both Singapore and Osaka insist that an owner of a futures contract must pay variation margin - covering the difference between the price at which the contracts were bought and their daily market price at the end of each day.

'Every day your broker sends slips in saying this is how much you are down. You get it every day and you need to pay up every day,' explains one observer. 'Brokers have to collect margins every day and report to the exchange.'

It is also understood that in order to raise the cash for margins the trader sold put options - giving a counterparty the right to sell the contract at a pre-fixed price - on the contract.

The effect of this would have been to leverage up the transaction, transforming an already highly geared trading strategy into a perilous double-or-quits game.

After a rally early last week, the Nikkei 225 contract slumped, losing some

250 points on Friday and [illegible]ing below its previous low f[illegible]e year.

The overall picture could be more complicated than this, however. The trader appears, at least initially, to have based his strategy on the difference in price - effectively arbitraging - between the Nikkei 225 contract listed in Osaka and that listed in Singapore. The contracts are not fungible - they cannot be traded on one exchange and settled on another.

In addition there may also have been some trade in the underlying Japanese stocks, possibly in an attempt to balance or 'hedge' the exposure on the derivatives contract.

By the weekend, the options available to Barings limited. The Nikkei contracts could have been sold and the position closed - but this would have left the bank with a serious capital loss. Alternatively, additional funds could be found to pay margin to the exchange or exchanges.

The contract would then have been left open in the hope that share prices would recover and the value of the Nikkei 225 index rise. If this were to happen, some of the variation margin would have been returned to the bank, reducing the overall loss could be reduced.

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* Record-keeping. An adequate record-keeping system must be established and kept updated. At a minimum, the system should produce daily reports showing the status of the securities, the outstanding loans (by borrower and count) and transactions by account.

* Administrative procedures, Collateral must be marked-to-market daily and there must be procedures to ensure that any necessary margin calls are made on a timely basis. There should be internal controls and periodic internal audits.
* Credit analysis and approval of borrowers. A duly established management or supervisory committee should formally approve transactions with any borrower in advance. Independent credit reviews should be conducted prior to approval and at regular intervals thereafter.

* Credit and concentration limits. Management should establish individual credit and concentration limits.

* Collateral management, Generally, the minimum initial collateral on securities loans is at least 102% of the market value of the loaned securities, plus any accrued interest on debt securities. The acceptable level of excess, non-cash collateral should relate to the price volatility of the loaned securities and the collateral. Finally, securities should not be loaned unless collateral has been received or will be simultaneously received with the securities loan.

* Cash collateral. Written guidelines should be established for selecting investments for cash collateral.

* Letters of credit as collateral. Written guidelines should be established for the use of letters of credit. Concentration limits on the banks issuing letters of credit should also be established.
* Written agreements. There should be detailed written agreements between the lender and the agent and the borrower and the agent.

* Finders. Finders bring together a borrower and a lender for a fee. Written policies should be in place concerning the use of Finders. Finders should not take possession of the collateral or securities and should not be involved in the delivery process.

* Employee benefits plans. Any institution engaged in lending securities for an employee benefits plan subject to the Employee Retirement Income Security Act of 1971 (Erisa) should take all steps necessary to design and maintain its program to conform to Prohibited Transition Exemptions 81-6 and 82-63.

* Indemnification. Agents offering indemnification to lenders should get written opinions from their counsel and accountants regarding the legality of the indemnification under federal and/or state law and the proper financial statement disclosure of actual or contingent liabilities,

respectively.

* Regulatory reporting. Financial institutions should follow the proper reporting requirements.
The supervisory policy applies to national banks and all state-chartered banks that have joined the Federal Reserve System.

Securities Exchange Commission--Rule 15c3-3

Brokers and dealers are also regulated by several rules under the Securities Exchange Act of 1934. Specifically, Rule 15c3-3 (17 CFR Sec 240.15c3-3--Customer Protection-Reserves and Custody of Securities) directly impacts the actions of brokers and dealers with respect to securities lending. Paragraph (b)(1) of the rule generally provides that a broker or dealer shall promptly obtain and maintain the physical possession or control of all fully-paid securities and excess margin securities carried by a broker or dealer for the account of customers. Since the definition of customer under Rule 15c3-3 is quite encompassing, a broker or dealer would not be able to enter into securities lending transactions with a customer's securities. However, paragraph (b)(3) provides an exception to retaining physical possession by providing that a broker or dealer shall not be deemed to be in violation of the provisions of paragraph (b)(1) if the broker or dealer and the lender, at or before the time of the loan, enter into a written agreement that, at a minimum;

* Sets forth in a separate schedule or schedules the basis of compensation for any loan and generally the rights and liabilities of the parties as to the borrowed securities;

* Provides that the lender will be given a schedule of the securities actually borrowed at the time of the borrowing of the securities;

* Specifies that the broker or dealer (A) must provide to the lender, upon the execution of the agreement or by the close of the business day of the loan if the loan occurs subsequent to the execution of the agreement, collateral, consisting exclusively of cash or US Treasury bills and Treasury notes or an irrevocable letter of credit issued by a bank as defined in Section 3(a) (6)(A)-(C) of the Securities Exchange Act which fully secures the loan of securities, and (B) must mark the loan to the market not less than daily and, in the event that the market value of all the outstanding securities loaned at the close of trading at the end of the business day exceeds 100 per cent of the collateral then held by the lender, the borrowing broker or dealer must provide additional collateral of the type described in proviso (iii)(A) above to the lender by the close of the next business day as necessary to equal, together with the collateral then held by the lender, not less than 100 percent of the market value of the securities loaned; and
* Contains a prominent notice that the provisions of the Securities Investor Protection Act of 1970 may not protect the lender with respect to the securities loan transaction and that, therefore, the collateral delivered to the lender may constitute the only source of satisfaction of the broker's or dealer's obligation in the event the broker or dealer fails to return the securities.

DEPARTMENT OF LABOR PROHIBITED TRANSACTION EXEMPTIONS 81-6 AND 82-63

Pension plans, in terms of the dollar amount of securities available for lending, account for a large percentage of the lenders. Until January 23 1981, pension plans subject to Erisa, were not permitted to lend securities because the brokers, dealers or banks would be considered parties in interest with respect to the pension plans. The Department of Labor issued two exemptions for Erisa plans. Prohibited Transaction Exemption 81-6 (46 FR 7527) issued January 23, 1981 (with corrections made at 46 FR 10570 issued February 3 1981 and amendments made at 52 FR 18754 issued May 19 1987) allowed Erisa plans to participate in lending securities under

certain conditions. These conditions are quite extensive but basically provide that the following items must be met:

* Neither the borrower nor an affiliate of the borrower has discretionary authority or control with respect to the investment of the plan assets involved in the transaction, or renders investment advice with respect to those assets;

* The plan receives from the borrower collateral consisting of cash, securities issued or guaranteed by the US Government or its agencies or instrumentalities, or irrevocable bank letters of credit issued by a person other than the borrower or an affiliate thereof, or any combination thereof having a market value equal to not less than 100% of the market value of the securities lent;

* Prior to the making of any such loan, the borrower shall have furnished the lending fiduciary with the most recent available audited and unaudited statements of the borrower's financial condition;

* The loan is made pursuant to a written loan agreement, the terms of which are at least as favourable to the plan as an arm's-length transaction with an unrelated party would be;

* The plan either receives a reasonable fee or has the opportunity to derive compensation through the investment of cash collateral;
* The collateral is marked-to-market and adjusted accordingly;

* The loan may be terminated by the plan at any time; whereupon the borrower must deliver security certificates identical to the borrowed securities, to the plan within (i) the customary delivery period for such securities, (ii) five business days, or (i) the time negotiated for such delivery, whichever is lesser; and

* In the event the loan is terminated, and the borrower fails to return the borrowed securities or the equivalent thereof within the time described in paragraph 7, above, (i) the plan may, under the terms of the loan agreement, purchase securities identical to the borrowed securities (or their equivalent as described above) and may apply the collateral to the payment of the purchase price, any other obligations of the borrower under the agreement, and any expenses associated with the sale and/or purchase, and (ii) the borrower is obligated, under the terms of the loan agreement, to pay, and does pay to the plan the amount of any remaining obligations and expenses not covered by the collateral plus interest at a reasonable rate.

Prohibited Transaction Exemption 82-63 (47 FR 14804) issued April 6 1982 (with corrections made at 47 FR 16437 issued April 16 1982) allowed the fiduciaries of Erisa plans to be compensated for services provided in lending securities under certain conditions. The conditions generally provide that:

* The loan of securities is not prohibited by section 406(a) of the Erisa;

* The lending fiduciary is authorized to engage in securities lending transactions on behalf of the plan;

* The compensation is reasonable and is paid in accordance with the terms of a written instrument; and

* The compensation is subject to the prior written authorization of an independent plan fiduciary and may be terminated by the authorizing fiduciary.

STOCK EXCHANGES

New York Stock Exchange (NYSE)--Paragraph (a) of Rule 296 of the NYSE (Liquidation of Securities Loans and Borrowings) provides that when members or member organizations have entered into an arrangement for the lending and borrowing of securities with each other, each member or member organization shall have the right to liquidate the transaction whenever the other party:

* applies for or consents to, or is the subject of an application for, the appointment of or the taking of possession by a receiver, custodian, trustee, or liquidator of itself or of all or a substantial part of its property;

* admits in writing its inability, or becomes generally unable, to pay its debts as such debts become due;

* makes a general assignment for the benefit of its creditors; or

* files, or has filed against it, a petition on under Title 11 of the US Code, or has filed against it an application for a protective decree under Section 5 of the Securities Investor Protection Act of 1970.

Rule 296 further provides that said liquidation right is available unless stayed, avoided or otherwise limited by an order under the Securities Investor Protection Act of 1970 or any statute administered by the Securities and Exchange Commission. Finally, paragraph (b) of Rule 296 states that no member or member organisation shall lend or borrow any security to or from any non-member except pursuant to a Mitten agreement.

Chicago Stock Exchange (CSE)--The primary CSE provisions governing the lending of securities are found in Rules 1 through 5 of Article XXIV. The rules are as follows:

Rule 1. Return of Securities Loaned Unless otherwise agreed, securities loaned may be returned on the next full business day following the day on which notice of intention to return the loan is made.

Rule 2. Notice of Intention to Demand Return The lender may require the return of a loan of securities on the next full business day following the day on which notice of intention to demand return of the loan is made.

Rule 3. Payment of Interest and Premium When securities are loaned, any premium payable by the borrower or the interest payable by the lender, shall be at such rates as are agreed upon.

Rule 4. Contract Not Affected An agreement to pay a premium because of a failure to deliver securities shall not change the nature of the contract and premiums on each subsequent day shall be payable only by mutual agreement. When any such agreement has been made, the party failing to receive shall be regarded as having waived his right to close out the contract under the rule on that day.

By mutual agreement a failure to deliver may be changed to a loan of securities in which event the contract shall be subject to all the rules applying to such loans.

Rule 5. Floor Employees Prohibited from Borrowing or Lending No floor employee of the exchange shall take any part in the borrowing or lending of securities.

American Stock Exchange (ASE)--ASE Rule 812 (Security Loans) indicates that if a party to a transaction is partially unsecured due to a change in market value, then that party can make a demand on the other party for an amount covering the difference between the contract price and the market price. Rules 860 through 866 of the ASE also dictate some of the mechanics of security loans, such as the payment, settlement, maturity and notice

provisions.

INVESTMENT COMPANY ACT OF 1940

An agent offering a securities lending program to lenders should use care in the structuring of its program. The investment of cash collateral on a pooled basis for the benefit of several lenders may present issues of whether the pooled fund constitutes an investment company within the definition of the Investment Company Act of 1940 (the Act).

This issue was raised in a no action ruling request in the First National Bank of Boston Fed. Sec. L Rep. (CCH 79,444). The First National Bank of Boston requested a no action ruling with respect to its securities lending program which pooled the cash collateral from several borrowers. The ruling request described the lending program and requested that the SEC rule that the program did not constitute an investment company. The SEC responded by stating that on the basis of the facts and representations it did not agree with The First National Bank of Boston's legal analysis. The SEC could not assure that it would not recommend that the Commission take any action against the Bank under the Act if the fund of cash collateral the Bank obtained and invested from borrowers of the securities it held in various fiduciary capacities was not registered under the Act.

However, even if the fund may be an issuer for purpose of the definition of the Act one or more exemptions may exclude it from the definition under Section 3(c) of the Act.
ARE OF CONCERN RISK OF LOSS

The participants in a securities lending transaction recognise that there are several risks inherent in such a transaction. Agreements between lenders and agents typically provide that the lender bears the risk of loss unless the agent is guilty of gross negligence or wilful misconduct.

One area of concern is that of the investment of cash collateral by the agent. If the market value of the securities the agent invested in declines, the primary issue is who bears the risk of loss. Lenders have traditionally attempted to reduce the risk of loss by obtaining indemnification protection from the agents. In recent years most agents have become less willing to include indemnification provisions in their agreements with lenders. Indemnification provisions vary in degree of coverage and depend on the parties' bargaining power and the economics of the transaction. Another element is the question of how losses in a securities lending program are allocated. Program's which pool all the cash collateral for investment may provide that losses are shared by all of the participants or losses maybe charged only to the lender directly affected by the loss.

If the agent is a bank, another indemnification issue is whether the bank has authority to indemnify the lender. In a Comptroller Staff Interpretative Letter (Letter No. 376, dated October 25, 1986) the Comptroller of the Currency indicated that national banks have the authority to provide indemnification. The Comptroller found that indemnification by national banks was an incidental activity to the securities lending business. Whether a state-chartered bank has the authority to provide indemnification is dependent on the banking statutes in the state where the bank is incorporated. As noted in the Supervisory Policy, agents should obtain written legal opinions as to the legality of indemnification under federal and/or state law.

Finally state-chartered banks that are members of the Federal Reserve System and bank holding companies must take into account the capital requirements necessary for indemnification provisions under the Risk-Based Capital Guidelines issued on January 18 1989 by the Federal Reserve System. Such banks must allocate capital to support the amount of their indemnification exposure. If the loan is fully collateralized with cash,

government securities or letter of credit, then the liability is in the 20% category; that is 20% of the value of the loan is a risk-weighted asset. Thus, such indemnity will have a minimum capital requirement of 20% of eight percent of the indemnified amount on a risk-weighted basis or 1.6%.

BANKRUPTCY

A related risk of loss issue concerns the bankruptcy of the agent, borrower or the entity in which the agent invested the cash collateral. Typically the lender and agent have provided for the bankruptcy of a non-lender participant in their contract. The main question involves the mechanics of proceeding against the collateral, if necessary. Section 362(a) of the United States Bankruptcy Code (the Code) provides that a petition for bankruptcy operates as an automatic stay against any entities attempting to gain possession or control of the asses in the bankrupt's estate, unless a court permits such action or an exception, such as Section 362(b)(6), applies. Basically, Section 362(b)(6) provides for the setoff by financial parties of any mutual debt and claim under or in connection with various contracts, including securities contracts. (See In re Amcor Funding Corp., 117 BR 549 (D Ariz 1990) where the court analyzed the legislative history of Section 362(b)(6) to indicate its purpose.)

Furthermore, Section 555 of the Code provides that certain lenders may liquidate securities contracts, pursuant to their contractual liquidation rights, in spite of an automatic stay. Section 555 qualifies this exception by stating that a liquidation can be delayed under the Securities Investor Protection Act of 1970 or the federal securities laws. According to an October 30 1990 letter from the Securities Investor Protection Corporation (SIPC), SIPC indicated that it would not seek court orders to delay such liquidations if the collateral was cash or letters of credit.

CONCLUSION

This article sets forth some of the major regulations in the US regarding securities lending and also presents basic concepts and issues surrounding a typical securities lending transaction. The business is large and growing. It facilitates a need of the securities industry and enables owners of large portfolios to increase their yields. However, there are complex business and legal issues involved which lenders should be aware of, analyze and monitor when participating in securities lending programs.

THIS IS THE FULL-TEXT.
GEOGRAPHIC NAMES: US

DESCRIPTORS: Securities regulations; Securities lending; Repurchase agreements; Regulation of financial institutions; Bankruptcy; Risk assessment
CLASSIFICATION CODES: 9190 (CN=United States); 3400 (CN=Investment analysis); 4310 (CN=Regulation)
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More for the money

ABSTRACT: As the vice president-lending at Atlantic Credit Union (Newtown Square, Pennsylvania), Joan Paylor is one of the growing number of satisfied borrowers in the credit union's Member Auto payment Saver program, which offers the low payments of a lease without all the fine print and additional fees. Like other lending managers at credit unions that offer lease look-alike loans, Paylor says these products require a fair amount of staff and member education but can give credit unions a competitive edge - or at least level the playing field in the lease market dominated by big banks and manufacturers' financing program.

Bankston, Karen
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USA: Legal aspects of securities lending and repo

ABSTRACT: Despite the substantial volume of securities lending transactions in the US, the regulations are limited, pertaining mostly to banks, brokers, and dealers in securities. Control and primary governance of securities lending are dictated by the contractual terms and provisions agreed to by the parties in such transactions. Federal Reserve System Regulation T states that a broker or dealer may borrow or lend securities for the purpose of making delivery of the securities in the case of short sales, failure to receive securities required to be delivered, or other similar situations. It also provides that each borrowing must be secured by one or more of the following: cash, securities issued or guaranteed by the US or its agencies, negotiable bank certificates of deposit and bankers acceptances issued by banking institutions in the US and payable in the US, or irrevocable letters of credit issued by a FDIC-insured bank or a foreign bank that has filed an agreement with the Board on Form FR T-2. Other securities regulations are discussed.

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The Barings Crisis: Complex jigsaw of trades emerging - How the deal was made and lost
RICHARD LAPPER
Financial Times, P 2
Monday, February 27, 1995

TEXT:
Full details of the derivatives trades which triggered the crisis at Barings have yet to emerge, but several pieces of what could prove to be a highly complex jigsaw are already tentatively in place.

The loss-making deals by the Barings trader, who was based in the bank's Singapore office, involved derivatives with a value reflecting - and moving in parallel with - the Nikkei 225 stock index, a contract listed on the Osaka Securities Exchange in Japan and the Singapore International Monetary Exchange, as well as on the Chicago Mercantile Exchange. The deal is thought to have involved trading in both Osaka and Singapore.

The trader is understood to have bought at least 20,000 - and according to some reports up to 40,000 - of these contracts expiring in mid-March, presumably on the assumption that their price would go up with the underlying stock market. Each point of the Nikkei 225 futures contract carries a value of Y1,000, so with the Nikkei 225 trading at levels between 18,000 and 20,000 in the first few weeks of this year, each future would have a value of some Y18m-Y20m (Pounds 117,000-Pounds 130,000).

Although the futures are straightforward instruments bearing no relation to the complex notes traded in the over-the-counter market, the size of the trades is regarded as exceptionally large by derivatives specialists.

'For a medium-sized bank 1,000 contracts was a bloody big trade; 10,000 of these contracts would be a very big deal indeed,' said one consultant.

Assuming the purchase of 20,000 contracts and a fall in price from Y19.6m to Y17.6m, losses would amount to Y40bn.

During the first few weeks of 1995, the value of the Nikkei fell, declining by about 6.5 per cent in the first three weeks of February.

Like other exchanges, both Singapore and Osaka insist that an owner of a futures contract must pay variation margin - covering the difference between the price at which the contracts were bought and their daily market price at the end of each day.

'Every day your broker sends slips in saying this is how much you are down. You get it every day and you need to pay up every day,' explains one observer. 'Brokers have to collect margins every day and report to the exchange.'

It is also understood that in order to raise the cash for margins the trader sold put options - giving a counterparty the right to sell the contract at a pre-fixed price - on the contract.

The effect of this would have been to leverage up the transaction, transforming an already highly geared trading strategy into a perilous double-or-quits game.

After a rally early last week, the Nikkei 225 contract slumped, losing some

250 points on Friday and [illegible]ng below its previous low f[illegible]e year.

The overall picture could be more complicated than this, however. The trader appears, at least initially, to have based his strategy on the difference in price - effectively arbitraging - between the Nikkei 225 contract listed in Osaka and that listed in Singapore. The contracts are not fungible - they cannot be traded on one exchange and settled on another.

In addition there may also have been some trade in the underlying Japanese stocks, possibly in an attempt to balance or 'hedge' the exposure on the derivatives contract.

By the weekend, the options available to Barings limited. The Nikkei contracts could have been sold and the position closed - but this would have left the bank with a serious capital loss. Alternatively, additional funds could be found to pay margin to the exchange or exchanges.

The contract would then have been left open in the hope that share prices would recover and the value of the Nikkei 225 index rise. If this were to happen, some of the variation margin would have been returned to the bank, reducing the overall loss could be reduced.

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